Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

NO. 79-725

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
Petitioner,
v.
CENTRAL MAINE POWER COMPANY,
Respondent.

On Petition For A Writ of Certiorari To the Supreme Judicial Court of the State of Maine

BRIEF FOR RESPONDENT IN OPPOSITION

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December 5, 1979

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NO. 79-725

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
Petitioner,
v.
CENTRAL MAINE POWER COMPANY,
Respondent.

On Petition For A Writ of Certiorari
To the Supreme Judicial Court
of the State of Maine

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Opinion of the Maine Supreme Judicial Court (Appendix A to Petition) is now reported at 405 A.2d 153 (Me. 1979). The Decree of the Maine Public Utilities Commission (Appendix B to Petition) is reported in 26 P.U.R. 4th 388 (Me. P.U.C. 1978).

JURISDICTION

The Petition filed by the Maine Public Utilities Commission seeks to invoke this Court's jurisdiction under 28 U.S.C. § 1257(3). This Court lacks jurisdiction because no substantial federal question was decided in the state proceedings.

QUESTIONS PRESENTED BY THE PETITION

The Petition of the Maine Public Utilities Commission seeks to present the following issues to this Court:

> 1. Whether the Maine Public Utilities Commission's adjustment of a public utility's book depreciation expense to account for plant financed by its deferred tax reserve is inconsistent with the normalization requirements of §167(*l*).
>
> 2. Whether §167(*l*) of the Internal Revenue Code, which prescribes a normalization method of accounting to be used by a public utility that uses accelerated depreciation, requires that a state regulatory agency's treatment of depreciation for rate making purposes be consistent with that method of accounting. (Petition p.2)

STATUTES AND REGULATIONS INVOLVED

The applicable provision of the Maine public utility law (Me. Rev. Stat., title 35, § 51) is set forth as Appendix D to the Petition. The provisions of the Internal Revenue Code cited by the Petition (26 U.S.C. § 167(*l*)) and Treasury Regulations thereunder (26 C.F.R. § 1.167(*l*)) are set forth as Appendix C to the Petition.

STATEMENT OF THE CASE

Rate Case. This rate proceeding began before the Maine Public Utilities Commission (the "Commission"). Central Maine Power Company ("Central Maine") on

January 16, 1978, filed with the Commission a revised schedule of rates pursuant to Me. Rev. Stat., title 35, § 64. The Commission suspended the revised schedule under Me. Rev. Stat., title 35, § 69 in order to investigate the propriety of the proposed rates under applicable provisions of the Maine public utility law, Me. Rev. Stat., title 35. At issue were Central Maine's rates and charges for electric service within the State of Maine.

***New England* Decision.** While the Central Maine rate case was pending before the Commission, the Maine Supreme Judicial Court (the "Maine Court") decided *New England Tel. & Tel. Co. v. Pub. Util. Com'n,* 390 A.2d 8 (Me. 1978) (the "*New England*" case). The *New England* case held that the Commission had erred in refusing to use a normalization method of accounting in determining just and reasonable rates for New England Telephone. The Maine Court ruled that the Commission's refusal to normalize constituted "an unreasonable exercise of power and an abuse of discretion" under Maine law (1) because the adjustment arbitrarily disregarded the normalization method of accounting (which the Commission had ordered New England Telephone to follow), and (2) because the refusal to normalize arbitrarily "placed New England in jeopardy of losing its ability to take accelerated depreciation [for federal income tax purposes]." (390 A.2d at 24) The Maine Court stated:

> In view of our decision that the Commission's actions were arbitrary with regard to the treatment of the accelerated depreciation issue it becomes *unnecessary for us to decide whether under the Internal Revenue Code, New England would lose its right to take accelerated depreciation* if the Commission persisted in imputing flow-through of the taxes deferred. Even though all indications, including the language of the Code and the stated purposes of §167(*l*), strongly

> suggest that result would obtain, it is unnecessary for us in this case to so declare. (*Ibid.; cf.* Appendix to Petition, p. 36)(Emphasis added)

The Maine Public Utilities Commission did not seek review by this court of the *New England* decision.

Section 167(*l*). Section 167(*l*) of the Internal Revenue Code was added by the Tax Reform Act of 1969 (P.L. 91-172). Under Section 167(*l*), a public utility may use accelerated depreciation for federal income tax purposes *only if* it uses a normalization method of accounting. (I.R.C. § 167(*l*)(2))

Normalization. Under the normalization method of accounting, a public utility (like Central Maine) that elects to use accelerated depreciation for federal income tax purposes, but computes depreciation expense for book purposes on the straight-line method, must for ratemaking purposes, have its depreciation expense and resulting tax expense determined on the straight-line method. (I.R.C. §167(*l*)(3)(G)) The difference between the tax computed by the straight-line method and the tax paid on the basis of accelerated depreciation in the early years of an asset's life—that is, the amount of deferred taxes—is set aside in a deferred tax reserve. (I.R.C. §167(*l*)(3)(G)(ii)) That reserve makes available to the public utility interest-free funds for plant expansion, service improvement, or other public utility purposes and to that extent reduces the utility's requirements for capital from external sources.

"Flow-Through." The term "flow-through" refers to any reduction in a public utility's federal income tax expense for ratemaking purposes (and thus the utility's rates) effectuated by computing that utility's federal income tax not on the basis of straight-line depreciation, but rather on the basis of accelerated depreciation. (Appendix to Petition, pp. 35-36) The benefits of accelerated depreciation

are thereby flowed through to utility ratepayers, rendering nugatory the Congressional purpose in providing the utility with the equivalent of an interest-free loan. Flow-through contravenes the normalization requirement of Section 167(*l*) and thus exposes the affected public utility to the risk of losing its eligibility to take accelerated depreciation.

Response to New England Decision. On the first day of hearings after the *New England* case was decided (July 10, 1978), the Commission Staff (acting as an advocate against Central Maine) abandoned its position in this proceeding which had argued for full flow-through and announced that it would propose an alternate adjustment. (Appendix to Petition, p. 37)

Commission counsel stated his reaction to the *New England* decision as follows:

> Now in light of the Supreme Court ruling in the Telephone Company case with reference to deferred federal income taxes and flowing through the benefits of the same, we may very well take the position that deferred federal income taxes are customer contributed capital and, therefore, recommend disallowing depreciation expense thereon. (Appendix to Petition, p. 37) (Emphasis added)

Partial Flow-Through. The Commission Staff, true to the advance warning of its counsel, ultimately proposed that the Commission effect a partial flow-through of Central Maine's deferred tax expense by disallowing as a ratemaking expense depreciation taken on that portion plant that was financed by deferred taxes. (Appendix to Petition, pp. 37-38) The Commission adopted the adjustment and reduced Central Maine's intrastate earnings for ratemaking purposes by some $641,500. (Appendix to Petition, p. 38, n. 23)

Rejection of Partial Flow-Through. The Maine Supreme Judicial Court recognized that the adjustment made by the Commission effected a partial flow-through of deferred taxes. On the authority of the *New England* case, the Maine Court found that the adjustment placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation for federal income tax purposes. (Appendix to Petition, pp. 42, 45, 56) The Maine Court held that the Commission's partial flow-through adjustment, ". . .would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes and therefore constitute '*an arbitrary exercise of the Commission's power and. . .an abuse of its discretion*' prohibited by state law. *New England Telephone, supra,* at 23." (Appendix to Petition, p. 42; 405 A.2d at 168) (Emphasis in original)

The Maine Court first analyzed the effect of the Commission's adjustment on Central Maine's eligibility to take accelerated depreciation. The Court then stated the issue before it as follows:

> The issue is thus squarely presented: does the Commission adjustment place Central Maine *in jeopardy of losing* its right to take accelerated depreciation by departing from the requirements of normalization? (Appendix to Petition, p. 45) (Emphasis added)

The Maine Court carefuly phrased the issue in terms of "jeopardy of losing" the right to take accelerated depreciation. The court did not say the issue is: Will Central Maine in fact lose its right to take accelerated depreciation? Rather the court deliberately asked: does the adjustment place Central Maine *in jeopardy*? On its finding that the Commission's adjustment placed Central Maine in jeopardy, the Maine Court held that the Commission's actions constituted an abuse of discretion *under Maine public utility law; the Maine Court did not decide whether Central Maine Power Company would lose its right to take accelerated depreciation under the federal tax laws.* (Appendix to Petition, p. 56)

ARGUMENT

I. The Court Does Not Have Jurisdiction To Entertain The Petition.

A. No substantial federal question was decided.

The Maine Court did not decide any substantial question of federal law in this case. Rather, the Maine Court analyzed the specific ratemaking adjustment made by the Commission and applied its earlier decision that any ratemaking adjustment which places a public utility in jeopardy of losing its eligibility to take accelerated depreciation is arbitrary action and an abuse of discretion under state law. (Appendix to Petition, pp. 42, 45, 56)

The Maine Court held that the adjustment made by the Commission placed Central Maine *in jeopardy.* (Appendix to Petition, pp. 45, 56) That holding does not amount to a decision of federal law. Under the precedent established in the *New England* case, the Maine Court was not required to find that Central Maine would *absolutely and certainly* lose its eligibility to take accelerated depreciation if the Commission's partial flow-through were upheld. Rather, the Maine Court was required only to *assess the risk* created by the Commission's adjustment and decide whether that risk made the Commission's action an abuse of discretion under state law.

B. The Maine Court declined to certify that a federal question was decided.

Before filing its Petition with this Court, the Commission sought from the Maine Court a certificate that a fed-

eral question was decided in this case, and was necessary to the result reached. Specifically, the Commission by Motion (Appendix A to this Brief) asked the Maine Court to declare that:

> This Court sustained Central Maine Power Company's appeal. . .holding that the Commission's adjustment did violate the normalization requirements of I.R. C. § 167(*l*), and that this decision was necessary to the judgment rendered. (Appendix A hereto, p.2a)

The Maine Court by Order dated October 12, 1979 (Appendix B hereto, pp. 6a-8a), declined to issue any certificate.

In refusing to grant the requested certificate, the Maine Court observed that "[t]he Court's opinion speaks for itself, without need for clarification." (Appendix B hereto, p. 6a) The Maine Court quoted the following paragraph of its opinion (among others) as "the ground of decision":

> If the action here taken by the Commission constitutes a flow-through of deferred taxes, it would, of course, deplete the source of interest-free capital Congress sought to insure by enacting §167(*l*), and would thus be inconsistent with national economic policy. Simultaneously, it would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes, and therefore constitute 'an arbitrary exercise of the Commission's power and. . .an abuse of its discretion' prohibited by state law. *New England Telephone, supra,* at 23. (Appendix B hereto, p. 7a) (Emphasis in original)

This Court has jurisdiction to review a state court decision by writ of certiorari only if (1) a substantial federal question was raised and decided in the state court proceeding, *and* (2) the decision was "a necessary ground for

reaching the judgment under review." *Herb v. Pitcairn,* 324 U.S. 117 at 128 (1945). This Court has stated:

> It is our purpose scrupulously to observe the long-standing rule that we will not review a judgment of a state court that rests on an adequate and independent ground in state law. (*Ibid*)

Here, the Maine Court's decision was grounded in state law. The Maine Court found that the Commission's partial flow-through constituted an arbitrary exercise of power and an abuse of discretion *under state law.* The Maine Court's conclusion that the adjustment placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation was subordinate to that state law determination.

C. Any federal question was insubstantial and not a necessary ground for the Maine Court's decision.

Any federal question incidentally considered by the Maine Court was insubstantial. The Maine Court did not consider the broader question whether full flow-through exposed a public utility to a risk of losing the right to take accelerated tax depreciation. The Maine Court had decided that issue in the *New England* case.

Neither did the Maine Court decide the federal question specifically reserved in the *New England* case: whether flow-through (full in the *New England* case, partial in the instant case) would result under the Internal Revenue Code in a loss of the utility's right to take accelerated depreciation.

The issue "squarely presented" below and determined by the Maine Court was: "does the Commission adjustment place Central Maine in jeopardy of losing its right to take accelerated depreciation . . ." (Appendix to Petition, p. 45). In assessing that jeopardy or risk the

Maine Court did indicate substantial agreement with the position taken by Central Maine Power Company that regulatory commission imposed accounting methods could result in adverse tax consequences to the utility under the Internal Revenue Code, (Appendix to Petition, pp. 48-49).

The Maine Court's assessment of the position of the parties on this "federal issue" was made, however, in the context of deciding a question of state law in both the *New England* case (390 A.2d at 23) and in the present case (Appendix to Petition, p. 42): would the Commission adjustment place Central Maine Power (or New England Telephone) in jeopardy of losing its right to take accelerated depreciation and therefore constitute an arbitrary exercise of Commission power and an abuse of discretion *prohibited by state law.*

Although the Maine Court in this case did not expressly reserve decision on the question whether regulatory imposed accounting standards will produce adverse tax consequences to the affected utility (as it did in the *New England* case), any view expressed concerning that "federal question" was unnecessary to the result reached. As was made clear in the *New England* case, the Maine Court would have reached the same result even if it had expressly reserved decision on the federal issue. Since the Commission adjustment had created the risk of adverse tax consequences, the Court concluded that the Commission erred as a matter of state law. Whether or not the Court reserved decision with respect to questions of federal law or expressed views on them was extraneous to the decision reached and therefore such questions were insubstantial.

In December of 1978, this Court denied *certiorari* in two companion cases seeking review of the question whether flow-through contravenes Section 167(*l*). *Pacific Tel. & Tel. Co. v. Pub. Util. Com'n*, 440 U.S. 931, 58 L.Ed.2d 713 (1978); *General Tel. Co. v. Pub. Util. Com'n,* 440 U.S. 931, 58 L.Ed.2d 713 (1978). The telephone utilities in those cases had filed petitions for review with the California Supreme Court seeking review of Decision No. 87838 of the California Public Utilities Commission entered on September 13, 1977. The California Supreme Court, without opinion, had denied the utilities' petitions for review on July 13, 1978, thereby upholding a decision of the California Public Utilities Commission requiring flow-through for rate making purposes.

The Maine Court did consider whether the specific adjustment made by the Commission, namely, the disallowance of depreciation on plant financed by deferred federal income taxes, was inconsistent with the normalization requirements of Section 167(*l*). The question was whether the specific adjustment made by the Commission, one of many that the ingenuity of regulatory commissions might invent to evade the purpose of Section 167(*l*), constituted a partial flow-through. The Maine Court found that the adjustment did constitute a partial flow-through and concluded that the Commission abused its discretion as a matter of state law in making the adjustment.

This case was decided on a state law ground, namely, that the Commission abused its discretion in making an adjustment having the potential of placing Central Maine in jeopardy of losing the right to take accelerated depreciation. The question whether the specific adjustment made in this case did constitute a partial flow-through under Section 167(*l*) was considered incidentally to the Maine Court's determination of a state law issue; that question is, however, insubstantial.

II. The Maine Court Was Correct.

A. The Commission adjustment constituted a partial flow-through of deferred federal taxes.

The Petition (pp. 9-10) argues that the disallowance of depreciation on plant financed by deferred taxes did not constitute a flow-through of those deferred taxes. The Maine Court stated:

> Full normalization requires that the *entire* deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account (namely, straight-line), and (b) the accelerated depreciation method used on the income tax return, be normalized. The methodology employed by the Commission results, instead, in a partial flow-through of those deferred taxes. That this end is accomplished not directly but by excluding from book depreciation a portion of the value of depreciable assets allowed for tax purposes under the rubric of a "*basis*" change is irrelevant. In either case normalization (and Congressional intent) is frustrated. In either case the amount of deferred taxes properly includible in the cost of service is reduced to the benefit of the ratepayers and to the detriment of the utility and national economic policy. (App., pp. 49-50) (Emphasis in original)

Examples 4 and 5 to I.R.S. Reg. § 1.167(*l*)—1(h)(2)(ii) emphasize that a public utility will not be deemed to use a normalization method of accounting if the *effect* of a *regulatory order* is to flow through a portion of the tax deferrals resulting from accelerated depreciation. Example 5 establishes that a flow-through of tax savings with respect to a certain proportion or percentage of a public utility's property, even though complete normalization is followed with respect to the remaining proportion, would not constitute a normalization method of accounting with respect

to *any* public utility property. A regulatory order requiring that method of accounting would result in the loss of the public utility's eligibility to take accelerated depreciation on *all* its public utility property, including that portion on which it had followed a normalization method of accounting.

The Commission's adjustment does exactly what Examples 4 and 5 proscribe; tax deferrals resulting from accelerated depreciation on a certain proportion of utility plant (*i.e.*, that proportion financed by deferred taxes) are flowed through to rate payers.

The Maine Court correctly ruled that the Commission's adjustment constituted a partial flow-through of the tax deferrals arising from accelerated depreciation. That partial flow-through exposed Central Maine to a risk of losing its eligibility to take accelerated depreciation and was therefore held to be an arbitrary exercise of the Commission's power and an abuse of it discretion under state law.

B. Section 167(*l*) of the Internal Revenue Code governs regulatory action.

The Petition (pp. 12-14) contends that even if the partial flow-through made by the Commission contravenes the normalization requirements of Section 167(*l*), Central Maine's eligibility to take accelerated depreciation is not in jeopardy because Section 167(*l*) governs only the method of accounting used by the *taxpayer*.

The Maine Court rejected that argument:

> . . .regulatory commission imposed accounting methods which violate the Internal Revenue Code will penalize the subject utility, irrespective of its reluctance to adopt such methods. A contrary conclusion would ask us to believe that Congress intended the strictures of § 167(*l*) to be merely advisory; that if state regula-

> tory agencies wish to defy national economic policy they are free to do so. Moreover, even a cursory reading of the I.R.S. Regulations and Private Letter Rulings cited to us makes it clear that, even if imposed by a regulatory body, accounting methods which violate § 167(*l*) would produce adverse tax consequences for the affected utility, (App., p. 48-49) (footnote omitted)

Internal Revenue Service Private Letter Ruling 7836038, dated June 8, 1978 issued with respect to "Taxpayer-Pacific Telephone & Telegraph Co." (Appendix C hereto), indicated that the Internal Revenue Service would deny the use of accelerated depreciation to that utility because the regulatory commission had prescribed "a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes." (Appendix C hereto, pp. 26a-27a). See also Internal Revenue Service Private Letter Ruling 7836048, dated June 9, 1978 issued with respect to "Taxpayer-General Telephone Company of California" (Appendix D hereto); I.R.S. Reg. § 1.167(*l*)-1(h)(2)(ii), Examples 4 and 5 (Appendix C of Petition, pp. 224-225).

It would be preposterous to suppose that Congress intended to require a public utility to *file* its rate cases on the basis of normalization but to leave the state regulatory commissions free to *impose* final rates on the basis of flow-through. Petitioner cites absolutely no authority to support its position that the accomplishment of a partial flow-through by indirect means is consistent with Section 167(*l*).

III. This Case Poses No Important Question Of Federal Law.

This is a rate case to establish intrastate rates under state law. The Maine Court's decision applied ratemaking principles under state law in finding the adjustment made

by the Commission to be an arbitrary exercise of power and an abuse of discretion. The ultimate question in any state rate-making proceeding is the justness and reasonableness of rates under state law (but, of course, subject to federal and state constitutional limitations). The Maine Court's finding that the specific adjustment made by the Commission placed Central Maine in jeopardy of losing its eligibility to take accelerated depreciation was based on state law and was itself a subordinate decision to the overall question of justness and reasonableness.

This is not a tax case. It would be inappropriate and premature for this Court to construe Section 167(*l*) in the context of the unique adjustment made by the Commission in this state rate proceeding. Any view expressed by this Court on this question in the context of an intrastate rate case would be advisory in nature. Conflicting interpretations of the tax law are best resolved in litigation between the taxpayer and the Internal Revenue Service. In such a context this Court's opinion would not be advisory in nature.

The Petition (pp. 7-11) urges this Court to resolve the "confusion that presently surrounds 167(*l*)" and thereby to restore the "delicate balance between state and federal areas of control." (Petition, pp. 9, 10) The only basis given by the Petition for that plea is the alleged inability of state courts to "come to grips with difficult and highly technical federal legislation." (Petition, p. 9)

This Court has recently denied *certiorari in Pacific Tel. & Tel. Co. v. Pub. Util. Com'n, supra,* 440 U.S. 931, 58 L.Ed.2d 713 (1978); *General Tel. Co. v. Pub. Util. Com'n, supra,* 440 U.S. 931, 58 L.Ed.2d 713 (1978). Considerations which militate against attempting to decide a federal tax question in the context of a state rate proceeding (even if it were substantial, which in this case, it is not) are equally applicable here and *certiorari* should also be denied.

The Petition argues that a major issue concerning the scope of Section 167(*l*) is present in this case. On the contrary, the only issue before the Maine Court in this case remotely resembling a federal issue was whether the specific adjustment made by the Commission, namely, the disallowance of depreciation on plant financed by deferred taxes, constituted a partial flow-through of deferred taxes. Having found that the Commission's adjustment constituted a partial flow-through, the Maine Court simply applied its holding in the *New England* case that any such adjustment constitutes arbitrary action and an abuse of discretion under state public utility law.

The Petition asks this Court to address a subsidiary issue in a rate case in which the ultimate issue was: What are just and reasonable rates for Central Maine under the Maine public utility law? The Petition asks this Court to consider whether or not the disallowance of depreciation on plant financed by deferred taxes is a partial flow-through in a context other than that in which such issues are directly and clearly raised as federal questions ripe for adjudication—*i.e.*, the confrontation between a taxpayer and the Internal Revenue Service. The adjustment made by the Maine Commission is one of many adjustments that a public utilities commission could attempt in trying to circumvent the intent of Section 167(*l*). Any ruling by this Court on the failure of the attempt made in this case would have no wide-ranging influence. The only result would be to render an advisory opinion to reinforce what is abundantly clear from the language and purpose of Section 167(*l*) and the Regulations and the Rulings of the Internal Revenue Service pertaining thereto: any attempt to disallow depreciation on plant financed by deferred taxes constitutes a partial flow-through of the benefits of accelerated depreciation and thus contravenes the strictures of Section 167(*l*).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition of the Maine Public Utilities Commission for a writ of *certiorari* should be denied.

DATED: December 5, 1979

Respectfully submitted,

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Respondent

APPENDIX

APPENDIX A

STATE OF MAINE

SUPREME JUDICIAL COURT

LAW COURT DOCKET NO. KEN-78-52

CENTRAL MAINE POWER COMPANY, *Plaintiff,*

VS.

PUBLIC UTILITIES COMMISSION,
Et als, *Defendant.*

Motion Requesting Certificate From The Law Court That A Federal Question Was Decided In Regard To The Provisions Of 26 U.S.C. § 167(*l*)

NOW COMES the Public Utilities Commission and moves as follows:

WHEREAS, The Maine Supreme Judicial Court sitting as the Law Court issued its decision in *Central Maine Power Company vs. Public Utilities Commission, et als.,* Docket Number Ken-78-52 on August 6, 1979; and

WHEREAS, The Law Court sustained the appeal of Central Maine Power Company in regard to the Commission's disallowance for ratemaking purposes of depreciation expense on plant financed by deferred taxes; and

WHEREAS, The Law Court, in sustaining the appeal, ruled that the Commission's adjustment violated the normalization provisions of 26 U.S.C. §167(*l*); and

WHEREAS, The Public Utilities Commission intends to petition for certiorari on that determination to the Supreme Court of the United States by invoking jurisdiction under 26 U.S.C. §1257(3) on the grounds that a substantial federal question was decided by the Law Court; and

WHEREAS, The Public Utilities Commission believes that a Certificate from this Court stating that a federal question was decided would greatly aid the Justices of the United States Supreme Court in determining whether to grant or deny the Petition for Certiorari;

NOW THEREFORE, The applicant Public Utilities Commission respectfully requests this Court to issue a Certificate stating that the Law Court held, in *Central Maine Power vs. Public Utilities Commission,* Docket Number Ken-78-52, that as a matter of federal law the Commission's disallowance of depreciation expense on plant financed by deferred taxes violated the normalization provisions of 26 U.S.C. §167(*l*) and that this decision was necessary to the judgement [sic] rendered.

Dated at Augusta, Maine this 27th day of September, A.D., 1979.

Respectfully submitted,

/s/ HORACE S. LIBBY
Horace S. Libby
Attorney

/s/ STEPHEN A. JOHNSON
Stephen A. Johnson
Attorney

NOTICE OF HEARING

To All Counsel:

Please be advised that counsel for the Maine Public Utilities Commission will bring this Motion forward for hearing before the Maine Supreme Judicial Court in Portland, Maine at 10 o'clock in the forenoon on Monday October 1, 1979.

/s/ HORACE S. LIBBY
Horace S. Libby
Attorney

/s/ STEPHEN A. JOHNSON
Stephen A. Johnson
Attorney

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served a copy of this motion by delivering it in hand or by mailing it, postage prepaid, first class, United States mail to each of the following;

Gerald M. Amero, Esquire, and James E. Purcell, Esquire, Pierce, Atwood, Scribner, Allen, Smith & Lancaster, One Monument Square, Portland, Maine 04111; Seward B. Brewster, Esquire, Central Maine Power Company, Edison Drive, Augusta, Maine 04336, Counsel for Central Maine Power Company; Mark L. Haley, Esquire, Fitzergald, Donovan, Conley & Day, 746 High Street, Bath, Maine 04530, Counsel for Maine Oil Dealers Association and 10 individual complainants; Thomas Schulten, Esquire, Perkins, Thompson, Hinckley & Keddy, One Canal Plaza, P.O. Box 426, Portland, Maine 04112; Margaret W. Dobbins, Esquire, St. Regis Paper Company, 150 East 42nd Street, New York, New York 10017, Counsel for St. Regis Paper Company; Paul A. Fritzche, Esquire, Pine Tree Legal Association, Inc., 277 Lisbon Street, Lewiston, Maine 04240; V. Louise McCarren, Esquire, P.O. Box 514, Burlington, Vermont 05401, Counsel for the Consumer Action Coalition, Maine Citizens Committee for Utility Rate Reform and Bruce M. Reeves; Virginia E. Davis, Esquire, Natural Resourses [sic] Council, 335 Water Street, Augusta, Maine 04330, Counsel for the Natural Resourses [sic] Council of Maine.

Dated at Augusta, Maine this 27th day of September, A.D., 1979.

/s/ HORACE S. LIBBY, ESQUIRE
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State House
Augusta, Maine 04333

The Maine Supreme Judicial Court sitting as the Law Court hereby certifies to the Supreme Court of the United States that in the appeal to this Court entitled *Central Maine Power Company vs. Public Utilities Commission, et als,* Law Court Docket Number Ken-78-52, there was properly presented and necessarily passed upon a substantial federal question, viz.: The Appellant, Central Maine Power Company, argued on appeal that a ratemaking adjustment ordered by the Maine Public Utilities Commission, disallowing as a ratemaking expense depreciation expense on plant financed by deferred taxes, violated the normalization provisions of I.R.C. §167(*l*), This Court sustained Central Maine Power Company's appeal on that point holding that the Commission's adjustment did violate the normalization requirements of I.R.C. §167(*l*), and that this decision was necessary to the judgement [sic] rendered.

Dated:

Charles A. Pomeroy
Acting Chief Justice

Edward S. Godfry [sic]
Associate Justice

Sidney W. Wernick
Associate Justice

David A. Nichols
Associate Justice

James P. Archibald
Associate Justice

APPENDIX B

STATE OF MAINE

SUPREME JUDICIAL COURT
SITTING AS THE LAW COURT

LAW COURT DOCKET
NO. Ken-78-52

CENTRAL MAINE POWER COMPANY,
Plaintiff

v.

PUBLIC UTILITIES COMMISSION, ET AL, *Defendants*

ORDER

On the Motion of the Public Utilities Commission representing that it *"intends to petition for certiorari. . .to the Supreme Court of the United States on the decision of this Court in Central Maine Power Co. v. Public Utilities Commission, et als., Docket Number Ken-78-52"* (Aug. 6, 1979), Me., A.2d. That decision, the motion states "sustained the appeal of Central Maine Power Company in regard to the Commission's disallowance for rate-making purposes of depreciation expense on plant financed by deferred taxes". As an aid in the Commission's Petition for Certiorari a Certificate[1] by this Court clarifying the ground of our decision is requested.

Upon consideration of said motion, the Court concludes:

(1) The Court's opinion speaks for itself, without need for clarification. In setting forth the ground of decision, more particularly the opinion states the following:

> *Our extensive review of the Legislative history of §167(1)* in New England Telephone need not be reiterated here, except to note again our conclusion that

[1] *See,* Stern & Gressman, *Supreme Court Practice,* 5th ed., §3.29 (1978).

> Congress intended "to create a deferred tax reserve which [*would provide*] interest free capital to the utility. . .for plant expansion. . .[Me., 390 A.2d 8, at 18]".
>
> *If the action here taken by the Commission constitutes a flow-through of deferred taxes, it would, of course, deplete the source of interest-free capital Congress sought to insure by enacting* §167(1), *and would thus be inconsistent with national economic policy. Simultaneously, it would place Central Maine Power in jeopardy of losing its right to take accelerated depreciation for federal tax purposes, and therefore constitute* "an arbitarary exercise of the Commission's power and. . .an abuse of its discretion" *prohibited by state law. New England Telephone, supra, at 23.*
>
> • • •
>
> *Congress forbade different methods of depreciation for tax and ratemaking purposes in order to provide interest-free investment capital for utility expansion. Regulation which results in the* "loan" being extended (by virtue of accelerated depreciation) but also in the utility being forced to divert a portion of it to other uses as income (by virtue of it being denied as an expense) does not comport with Congressional intent. The result must surely be denial of the "loan" *i.e., the loss of the right to accelerated depreciation.*
>
> *As we observed in New England Telephone, normalization of a utility's regulated books of account does not meet the* §167(1) requirement of normalization if these books may be disregarded by the Commission in setting rates. Where the Commission set rates reflecting a lower depreciation expense that it permits to be taken for tax purposes, a partial flow-through results (whether the Commission wishes to

thus characterize it or not) in the form of lower rates. The utility thus loses, as a direct consequence, the full benefit of the deferred taxes it is allowed, and is further placed in jeopardy of losing entirely its right to take accelerated depreciation.

Central Maine Power Co., supra, slip. op. at 35-36, 48-49.

(2) The Court's decision being thus grounded, the dispute between the parties is really one of characterizing the decision for purposes of determining whether it meets the jurisdictional requirements of the Supreme Court of the United States for the granting of certiorari under 28 U.S.C. §1257;[2]

(3) That determination is for the Supreme Court of the United States under the jurisdictional principles laid out in the statute, as that Court interprets them. It would be inappropriate at this time for this Court to make any characterizing statement.

It is therefore ORDERED that the Motion of the Public Utilities Commission for this Court's Certificate be DENIED.

Dated: October 12, 1979

For the Court:

/s/ CHARLES A. POMEROY
Acting Chief Justice,
pursant to 4 M.R.S.A. §1

All Justices concurring.

McKusick, C.J., and Glassman, J., did not sit.

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[2] *See*, Stern & Gressman, *supra* at §3.32.

APPENDIX C

PRIVATE LETTER RULING 7836038

INTERNAL REVENUE SERVICE DEPARTMENT OF THE TREASURY

Index Number 0167.23-00

Washington, DC 20224

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph
Company
140 New Montgomery Street
San Francisco, California 94105

Date: 8 June 1978

Taxpayer—Pacific Telephone & Telegraph Co.*

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision X—87838, September 13, 1977

Dear Mr. Dalenberg:

This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation

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* The comparable ruling issued to General Telephone Company of California is printed herein as Appendix D, infra, pp. .

Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issues at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on

straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer in using an accelerated method of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(*l*)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the power limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issued a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the

Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative, but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission issued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagred with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74-6/30/75 and; 3) fiscal year 7/1/75-6/30/76. The Commission ordered the taxpayer to make refunds and annual reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjusted for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years.

As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167(*l*)-1(h)(6) of the regulations is satisfied and eligibility is maintained for

accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 167(*l*) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the

Commission as being inconsistent with section 167(*l*) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(*l*)-1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(*l*)-1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test

year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(*l*)-1(h)(1)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(*l*)-1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(*l*)(1)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(*l*)-1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969

vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167(*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-11(a)(1) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)-11(b)(6)(ii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167(*l*)(3)(G) of the Code and 1.167(*l*)-1(h).

Section 1.167(a)-11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)-12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting

shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (*l*) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(d)(2)(ii) of the regulations provides that under section 167(*l*)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (*l*) method or a method of depreciation otherwise allowable under section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of

any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of that period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1,

1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking pur-

poses was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1

(h)(1)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167(a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for ratemaking purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and flow-through whether

imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(*l*)(2)(B) of the Code and section 1.167(*l*)-1 (d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973-1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the

form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(1)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant

additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969 public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours,

/s/ GEOFFREY J. TAYLOR
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

APPENDIX D

PRIVATE LETTER RULING 7836048

INTERNAL REVENUE SERVICE
Index Number 0167.23-00
Mr. A. M. Hart
General Telephone Company
of California
100 Wilshire Boulevard
Santa Monica, California 90401

Department of the Treasury
Washington, DC 20224

Date: 9 June 1978

Taxpayer—General Telephone Company of California

State—California

Commission—California Public Utility Commission

Parent—General Telephone & Electronics Corporation

Representatives—Covington & Burling

Decision X—87838—September 13, 1977

Dear Mr. Hart:

This replies to a ruling request, dated September 29, 1977, as supplemented, the latest being dated April 21, 1978, filed on your behalf by your representatives.

You request a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit if Decision No. X of the Commission, dated September 13, 1977 becomes final?

Taxpayer is a wholly owned subsidiary. The principal offices of its Parent are at One Stamford Forum, Stamford, Connecticut 06940. Taxpayer is principally engaged in the business of providing telephone service to residential, commercial, and industrial customers within the state of its incorporation, and its intrastate rates are regulated by the Commission of that state.

By letter dated January 24, 1978 you stated that you are concerned with a timely response to the issues concerning accelerated depreciation under section 167(*l*) of the Internal Revenue Code of 1954 and the CL system with respect to pre-1971 property. You ask that the ruling request be treated as two separate ones, with the response to the two depreciation issues first, and the response to the investment credit issue at a later date. In compliance with that request, we are ruling on the first two issues in this ruling letter and will reply to the investment tax credit issue at a later date.

In 1960 the Commission determined that the flow-through method of accounting was mandatory for utilities electing accelerated depreciation for tax purposes. The election of accelerated depreciation was left to the utility companies and taxpayer remained on straight line depreciation for tax purposes through 1969.

For its pre-1970 public utility property taxpayer used straight line depreciation for computing both its tax expense and depreciation expense for establishing its cost of service for ratemaking purposes, in its regulated books of account, and for actual tax purposes.

After August 1, 1969, the taxpayer, in accordance with the Tax Reform Act of 1969, made a timely election to use accelerated depreciation for its post-1969 public utility property. It was permitted to do so by the Commission and to normalize the deferred taxes beginning with the year 1970.

The proceedings that resulted in Decision No. X, followed the remand by the State Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted another public utility and taxpayer, relating to accelerated depreciation and investment tax credit. In the remand of the case the court held that the Commission has the power to implement an alternative method, one that involves an annual adjustment of the tax expense treatment for acceler-

ated depreciation and investment tax credit. The timely election by the taxpayer of accelerated depreciation, commencing with its taxable year 1970, led to the proceedings in which the Commission in its Decision No. X has attempted to comply with the mandate from the court to reach an equitable determination of the election of accelerated depreciation. In its presentation of the "average annual adjustment method," the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the Income Tax Regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes. The taxpayer has before the Commission three rate cases using calendar year test periods 1970, 1974 and 1976.

It seems that the Commission viewed the full flow-through as being the proper and best ratemaking method, but since the taxpayer was not using an accelerated method of depreciation on August 1, 1969, flow-through could not be required.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed the "average annual adjustment method."

Decision No. X states that the theory of this method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses actual deferred tax amounts through 1976 and estimated amounts thereafter. This method consists of taking the simple aver-

age of the average annual reserve for deferred tax for both pre-1970 public utility property and post-1969 public utility property for the four year period and deducting this amount from the rate base, adjusted for the test year depreciation reserve, but not for the additional depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this deferred tax reserve from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income figure was then substituted in the cost of service for the larger net operating income figure of the test year and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the test year's larger tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The depreciation expense, included in the cost of service, was left undisturbed.

Decision No. X states that pertinent sections of the Internal Revenue Code and regulations thereunder do not discuss the estimating process. Apparently, the Commission is of the view the method set forth in its decision uses the same time period for estimating both the reserve for deferred taxes and the tax expense for cost of service for ratemaking purposes; that section 1.167(*l*)-1(h)(6) of the regulations is satisfied; and eligibility for accelerated depreciation is maintained because while the method is different, the principle is identical to the ordinary test year principle. The Commission seems to take the view that the taxes set aside in the reserve for deferred tax account will never be paid and thus will amount to an actual tax savings rather than a tax deferral.

In reviewing the record of the taxpayer's proceedings it came to the attention of the Commission that 1969 vintage plant additions were not previously considered in the ratemaking process. Decision No. X therefore included the 1969 vintage accounts in the ratemaking process by imputing flow-through of accelerated depreciation for that property.

In a previous Commission decision, it imputed flow-through of accelerated depreciation for taxpayer for its 1968 vintage plant using a 1968 test year. In a later decision, the Commission ordered increased rates using the normalization method of accounting for the accelerated depreciation beginning with 1970 vintage plant additions. The 1969 vintage plant additions never were reflected in taxpayer's rates. Imputed accelerated depreciation and flow-through was proposed by the Commission for the 1969 vintage plant additions and adopted in Decision No. X and continued through tests years 1970, 1974 and 1976.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 property for taxable years beginning with the year 1971, and has consistently used the straight line method of depreciation for both book and tax purposes for the 1969 vintage accounts and prior year accounts.

The taxpayer cites sections 1.167(*l*)-1(a)(1) and (2) and 1.167(*l*)-1(h)(6) of the regulations, and states that these regulations mandate synchronization of the reserve for deferred taxes that is deducted from the rate base with the corresponding tax expense that is included in the cost of service. It also states that, in accordance with section 1.167(*l*)-1(a)(1) the reserve for deferred taxes is to be increased only by the excess accelerated depreciation over the depreciation used in computing both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes.

The Commission had stated that based on an exhibit submitted by the taxpayer in a rate case, the actual Federal

tax expense bears no direct relation to the increase in deferred tax reserve but fluctuates independently of it. The taxpayer states that the figures in this exhibit need to be adjusted for straight line depreciation and investment tax credit to portray normalized tax expense. A table was submitted by taxpayer showing that actual increased plant additions resulted in additional revenues, Federal income tax expense, and net operating income over a period of seven years.

The taxpayer believes that since the increased depreciation accruing from the estimated plant additions has not been used to compute the depreciation expense included in the cost of service for ratemaking purposes, the estimated reserve for deferred taxes does not exist and there can be no additional exclusion from the rate base. The taxpayer also states the Commission's average annual adjustment method would require more than a permissible deduction of the reserve for deferred taxes from the rate base and the taxpayer would not be permitted to use an accelerated method of depreciation.

In regard to the election of the CL system, taxpayer states that, in conformity with section 1.167(a)-12(a)(4)(iii) of the regulations, and using straight line depreciation, it has normalized the difference in depreciation between that which is based on the longer lives used for book purposes and that which is based on the shorter CL system lives used to compute depreciation for actual tax purposes.

The taxpayer states it has never used accelerated depreciation for its 1969 vintage plant additions. Thus, the deferred tax reserve required to be flowed-through by the Commission's imputed accelerated method of depreciation does not actually exist on taxpayer's books. Taxpayer states that the flow-through is a purely hypothetical deferred tax reserve that would have developed by reason of the difference between the fictional tax based on accelerated depreciation and the actual amount of tax paid based on straight line depreciation.

The taxpayer has normalized and will continue to normalize all tax deferrals resulting from the election of the CL system.

The taxpayer believes that if a taxpayer who is required to normalize with respect to qualified public utility property fails to normalize, the election to apply class lives shall terminate as of the beginning of the tax year for which the taxpayer fails to normalize. Taxpayer believes that since Decision No. X imputed flow-through with respect to its 1969 vintage plant additions beginning in 1970, it will not be entitled to use class lives for such property for any year.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167 (*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to

compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-12(a)(1) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970 and applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property for which no guideline life was prescribed in Rev. Proc. 62-21 shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is, the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.67(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (1) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting

operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2)(i) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flow-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed-through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969 regarding methods of depreciation by enacting 167(*l*) of the

Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.
2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.
3. If the taxpayer was taking accelerated depreciation and flowing-through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permitted it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The questions presented, whether the taxpayer will remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Code and 2) depreciation based on the CL system with respect to the pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167 (*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years through 1976 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is

absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

In regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions, the use of this system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The imputed flow-through of accelerated depreciation for the 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to the elective use the CL system will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

A schedule submitted by taxpayer, dated September 29, 1977, showed that its revenues, Federal income tax expense and net operating income increased, along with the addition of plant facilities, over a period of 7 years (1970-1976 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the Staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153 it states that the taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense, thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL

system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii).

Very truly yours,

/s/ Geoffrey J. Taylor
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch